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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

IVAN AND JOANNE SCHATZ,

Petitioners,

v.

WEINBERG AND GREEN,

Respondent.

Petition for a Writ of Certiorari To the United States Court of Appeals for the Fourth Circuit

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QUESTIONS PRESENTED

1. Whether attorneys who knowingly assist their clients in perpetrating a fraud should be exonerated from liability under the Federal Securities laws, specifically, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, on the grounds that the attorneys owed no duty to third parties.

2. Whether attorneys who knowingly assist a client in carrying out a fraudulent stock sale transaction should be liable under the Federal Securities laws as aiders and abettors of a fraud where,

   (1) the attorneys had actual knowledge of the fraud and,

   (2) prepared legal documents perpetuating the fraud.

3. Whether attorneys have a duty under the Federal Securities laws not to knowingly restate or perpetuate their clients' misrepresentations.

LIST OF PARTIES

The Plaintiff-Petitioners are Ivan and Joanne Schatz, husband and wife. The Defendant-Respondent is Weinberg and Green, a law firm based in Baltimore, Maryland. There were three other defendants in the District Court who settled with Plaintiffs and were not involved in the appeal to the Court of Appeals and are not respondents herein. They are Mark E. Rosenberg, Stephen Jaeger, and MER Enterprises, Inc. MER Enterprises, Inc. has no parent companies, subsidiaries or affiliates and is not publicly traded.

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DECISIONS BELOW

The opinion of the Fourth Circuit Court of Appeals, *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991) is appended (app. pp. 1-50). The unreported opinion and order of the District Court for the District of Maryland both initially (app. pp. 136-157) and upon reconsideration (app. pp. 158-161) and the report and recommendation of the U.S. Magistrate (app. pp. 51-135) are also appended.

JURISDICTION

The opinion of the Court of Appeals was filed on August 26, 1991. A timely petition for rehearing was

filed on September 9, 1991. The petition for rehearing was denied by the Court of Appeals by order of October 1, 1991. A copy of this Order is appended (app pp. 161-62). This Court has jurisdiction under 28 U.S.C. § 1254.

STATUTES INVOLVED

The relevant statutes are Section 10(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 CFR § 240.10b-5. This statute and regulation is produced in pertinent part in the Appendix to this petition (app. pp. 164-65).

STATEMENT OF THE CASE[1]

Petitioners Ivan and Joanne Schatz (the "Schatz") Plaintiffs below, sold controlling stock interests in their corporations to entrepreneur Mark E. Rosenberg's ("Rosenberg") holding company. The Schatz' sold their stock in exchange for a series of deferred payment promissory notes. The only real security in the deal was Rosenberg's personal guarantee of the notes. Rosenberg claimed to have a net worth of $7 million and gave the Schatz' a financial statement to that effect. The Schatz' sold their stock on the strength of the financial statement. The financial statement was phony. Within seven months, Rosenberg's flagship company was bankrupt. Rosenberg himself declared bankruptcy a little more than a year later. The Schatz' lost everything.

Rosenberg's attorney regarding the stock sale was the Baltimore law firm of Weinberg and Green. The

[1] This case concerns dismissal of a Complaint under F. R. Civ. Pro. 12(b)(6). The foregoing facts are drawn from the allegations contained in Petitioners' Second Amended Complaint.

Schatz' discovered that Weinberg and Green had been well aware that their client, Rosenberg, was in financial hot water at the time that the sale closed. The Rosenberg $7 million financial statement was dated March 31, 1986. The deal closed December 31, 1986. Between March and December, Rosenberg went into financial free fall. This was mainly due to the financial problems of Rosenberg's "flagship" company, Yale Sportswear, Inc.

Weinberg and Green knew that Rosenberg was in financial free fall because they represented Rosenberg in July 1986 when he secured additional credit to help shore up Yale Sportswear, Inc. This additional credit totalled $3.2 million by December 8, 1986. Weinberg and Green also represented Rosenberg in another transaction that also closed on December 31, 1986 involving a nursing home management company whereby that company lost management contracts worth (by Rosenberg's own calculations) $1.25 million on his financial statement. Indeed, Weinberg and Green was general counsel to Rosenberg and all of his companies, including the floundering Yale Sportswear.

The law firm of Arent, Fox, Plotkin & Khan ("Arent, Fox") represented the Schatz' in the deal. Arent, Fox knew that Rosenberg's financial statement was dated March 31, 1986. Arent, Fox demanded that Rosenberg provide a new financial statement encompassing March-December transactions. Weinberg and Green said on behalf of Rosenberg that Rosenberg would provide an update letter stating that there had been no material adverse change in his financial status since the March 31, 1986 financial statement. The lawyers negotiated the language of the update letter

and the language to be used in the closing papers referencing the update letter.

The deal closed, with Weinberg and Green drafting the closing papers. At no time did Weinberg and Green tell the Schatz' about the financial transactions it had concluded on behalf of Rosenberg which materially adversely affected Rosenberg's March 31, 1986 financial statement. Nor did Weinberg and Green withdraw from closing the deal. The stock sale went forward, assets were stripped from the purchased businesses, and Rosenberg defaulted on the promissory notes.

The Schatz' commenced this litigation in the United States Bankruptcy Court for the District of Maryland against Rosenberg, MER Enterprises, Inc., a holding company controlled by Rosenberg, Stephen Jaeger (a former bank officer who became Rosenberg's advisor) and the law firm of Weinberg and Green. The Schatz' invoked the Bankruptcy Court's jurisdiction pursuant to 28 U.S.C. § 1334(b) and pursuant to 28 U.S.C. § 1331. Upon withdrawal of the reference, the case was transferred to the United States District Court for the District of Maryland from the Bankruptcy Court.

On January 24, 1990, the United States Magistrate recommended that the Complaint be dismissed as to Weinberg and Green pursuant to F. R. Civ. Pro. 12(b)(6) on the grounds that Weinberg and Green owed no duty to disclose their clients' fraud to the Schatz'. (app. pp. 51-135). On March 8, 1990, the District Court entered an order essentially to the same effect. (app. pp. 155-57). On October 15, 1990, the District Court denied a Motion for Reconsideration. (app. pp. 158-61). After settling with the remaining

defendants, the Schatz' filed a timely appeal to the United States Court of Appeals for the Fourth Circuit. The Fourth Circuit affirmed.

The Court of Appeals ruled in a broad opinion that attorneys owe no duties to disclose to third parties absent a fiduciary or similar relationship. The Fourth Circuit concluded that "unless a relationship of trust and confidence exists between a lawyer and a third party, the Federal Securities laws do not impose on a lawyer a duty to disclose information to a third party." 943 F.2d at 492. (app. pp. 22-23). Indeed, the Fourth Circuit stated that "attorney liability to third parties should not be expanded beyond liability for conflicts of interest." 943 F.2d at 493. (app. p. 28). After a timely Petition for Rehearing and Suggestion for Rehearing *En Banc* was denied on October 1, 1991 (app. pp. 162-63), the Plaintiffs timely filed this Petition for a Writ of Certiorari.

REASONS FOR GRANTING THE WRIT

This case presents the legal question of attorneys' duties to third parties under the Federal Securities laws. The Fourth Circuit's bright line "no duty" ruling raises serious and troubling issues. The Fourth Circuit's ruling effectively immunizes attorneys from liability to third parties even where attorneys knowingly assist their clients in perpetrating a fraud. Put another way, this case presents the question whether attorneys to a buyer of securities can be liable for knowingly assisting their client in documenting and closing a fraudulent deal where they knew the deal to be fraudulent.

I. THE RULING OF THE COURT OF APPEALS THAT ATTORNEYS WHO KNOWINGLY ASSIST THEIR CLIENTS IN THE PERPETRATION OF A FRAUD CANNOT BE FOUND LIABLE UNDER FEDERAL SECURITIES LAWS BECAUSE THEY OWE NO DUTY TO THIRD PARTIES IS WRONG AND CONTRARY TO THE DECISIONS OF AT LEAST TWO OTHER COURTS OF APPEALS.

In *Chiarella v. United States*, 445 U.S. 222 (1980), this Court held that silence, absent a duty to disclose, does not violate Section 10(b) and Rule 10(b)(5). In *Dirks v. S.E.C.*, 463 U.S. 646, 657-58 (1983), this Court reaffirmed that "a duty to disclose arises from the relationship between the parties" (Citing *Chiarella*). This case presents a similar issue not addressed in *Chiarella* or *Dirks*—the nature of an attorneys' duties to third parties regarding a stock sale documented by the attorneys.

The Court of Appeals held that an attorney is not under a duty to disclose fraud to a third party. The only time such a duty would arise, according to the Court of Appeals, would be if a relationship of trust or confidence exists or if an attorney affirmatively undertakes to give an opinion letter to an opposing party. The Court of Appeals specifically rejected finding a duty to disclose 1) arising from a law firm's affirmative participation in a deal known to be fraudulent, 2) in ethical requirements or 3) in public polity.

The Court of Appeals' holding is directly contrary to numerous district court cases which hold that attorneys can be liable to third parties for fraud, *i.e.*, *Boltz v. Flagship Partners Limited Partnership*, No. 89 C 9103 (N.D. Ill. Aug. 22, 1990) (complaint stated cause of action against law firm that drafted offering memorandum containing representations the firm

knew to be false); *In re: ZZZZ Best Securities Litigation*, No. CV 87-3574 RSWL (C.D. Cal. July 23, 1990) (attorneys violate Section 10(b) by drafting false prospectus and registration statement); *In re: Flight Transportation Corporations Securities Litigation*, 593 F. Supp. 612, 617-18 (D. Mn. 1984) (attorneys could be liable for preparing false or misleading prospectuses; duty arose from undertaking preparation of prospectuses); *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1489 (D. Oregon 1985) (defendant attorneys could be liable for preparation of false prospectus and failure to update same); *Rose v. Arkansas Valley Environmental and Utility Authority*, 562 F. Supp. 1180, 1206 (W.D. Mo. 1983) (duty to disclose can arise from preparation of information to be distributed and relied on by third party).

The Court of Appeals' decision is also contrary to two recent Court of Appeals' decisions. The first is *Ikuno v. Yip*, 912 F.2d 306 (9th Cir. 1990). There the Ninth Circuit reversed a grant of summary judgment in favor of an attorney who represented a company which perpetrated a fraudulent commodity scheme. The attorney had incorporated the company and had filed two annual report forms. He had also negotiated a lease. This was enough to create an issue for the trier of fact regarding the attorney's civil RICO liability. Under the Court of Appeal's decision, the attorney in *Ikuno v. Yip*, would have had no liability since he would have owed no duties to defrauded third parties.

In a Securities Law context, the Court of Appeals' decision is contrary to *Breard v. Sachnoff & Weaver, Ltd*, 941 F.2d 142 (2d Cir. 1991). There, the Second Circuit found that attorneys for a Limited Partnership

had a duty to disclose adverse material facts to prospective limited partner investors in offering memoranda. The Fourth Circuit's broad "no duty" holding cannot be squared with *Breard*.

Finally, the Court of Appeals' decision is contrary to long-established *dicta* in numerous cases stemming from this Court's decision in *National Savings Bank v. Ward*, 100 U.S. 195, 205-06 (1879)("where there is fraud or collusion the [attorney] will be held liable even though there is no privity of contract"). *See* e.g. *Arthur Pew Construction Co., Inc. v. First Nat. Bank of Atlanta*, 827 F.2d 1488, 1493 (11th Cir. 1987) (same); *Allied Financial Services, Inc. v. Easley*, 676 F.2d 422, 423 (10th Cir. 1982) ("attorney owes a duty to his adversary not to engage in fraudulent or malicious conduct") (applying Colorado law); *Flaherty v. Weinberg*, 303 Md. 115, 492 A.2d 618, 620-21 (1985) (attorneys not primarily liable to nonclient third parties "absent fraud").

The Fourth Circuit's broad holding is without precedent. The Fourth Circuit relied upon a series of cases finding no duty to disclose notably, *Barker v. Henderson, Franklin, Starnes and Holt*, 797 F.2d 490 (7th Cir. 1986) and its progeny in the Seventh Circuit and *Abell v. Potomac Insurance Company*, 858 F.2d 1104 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989) in the Fifth Circuit.

None of the cases relied upon by the Court of Appeals presented a case where attorneys were alleged to negotiate and knowingly draft false or fraudulent documents upon which opposing parties rely. *See Renovitch v. Kaufman*, 905 F.2d 1040 (7th Cir. 1990) (finding defendant attorneys had no duty to disclose where the attorneys had not prepared or authorized

the preparation of fraudulent brochures and had no communications with plaintiffs); *Barker v. Henderson, Franklin, Starnes and Holt, supra,* (upholding summary judgment in favor of defendant attorneys where the attorneys had not prepared or authorized the preparation of fraudulent brochures and had no communications with plaintiffs.)

District Courts within the Seventh Circuit, for example, have not applied *Barker* and its progeny to cases such as this one where attorneys knowingly negotiate and/or draft false or fraudulent documents. *See Renovitch v. Stewardship Concepts, Inc.*, 654 F. Supp. 353 (N.D. Ill. 1987) (distinguishing *Barker* at motion to dismiss stage); *Ferguson v. Lurie*, N. 89 C 2283 (N.D. Ill., October 31, 1990) (1990 W.L. 180582) (distinguishing *Barker* and denying motion to dismiss where Complaint alleged that lawyers had advised defendants in connection with a fraudulent deal and drafted fraudulent documents).

The Court of Appeals rejected the common-sense rule of law invoked by other courts, i.e. that an attorney's duty to disclose "arises from knowing assistance of or participation in a fraudulent scheme." *In re: U.S. Grant Hotel Association Limited Securities Litigation*, 740 F. Supp. 1460, 1464 (S.D. Ca. 1990)(Citing *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973)). The rule of law to be applied on the facts alleged in this case presents an issue worthy of this Court's review.

II. THE RULING OF THE COURT OF APPEALS WRONGLY FINDS NO AIDING AND ABETTING LIABILITY

This Court has reserved ruling on whether Section 10(b) permits aiding and abetting liability. *Herman &*

MacLean v. Huddleston, 459 U.S. 375, 379 n. 5 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-92 n. 7 (1976). That issue is presented here, where the law firm negotiated language in the closing documents and prepared closing documents, knowing that a fraud was being committed.

In that regard, the Court of Appeals established a "scrivener exception" to attorney liability. That is, the Court of Appeals held that where a law firm simply "papers" a deal initially negotiated by clients, the law firm cannot be held liable for misrepresentations made by the client in a financial disclosure statement, even on an aiding and abetting theory. *See* 943 F.2d at 497. (app. pp. 43-44). According to the Court of Appeals, actual knowledge that a fraud was being committed is apparently not enough. "[T]he lawyer must actively participate in soliciting sales or negotiating terms of the deal. . . ." 943 F.2d at 497. (app. p. 45).

The existence, nature and extent of the Court of Appeal's "scrivener exception" also warrants review. No other court has so squarely held. The District Court opinion relied upon by the Fourth Circuit, *Friedman v. Arizona World Nurseries, Ltd.*, 730 F. Supp 521 (S.D. NY 1990) does not stand for that proposition. In *Friedman*, the Court found no cause of action against attorney defendants where there were no facts pleaded as to why the attorneys knew that the offering memorandum prepared by the attorneys contained false and misleading information:

> There are no allegations that [the attorneys] had any specific communications or that they had met with any specific individuals which

> facts would have created the necessary strong inference that each of the attorney defendants have the requisite fraudulent intent". 730 F. Supp. at 534.

In this case, Weinberg and Green represented Rosenberg in connection with specifically identified adverse, material financial transactions during the time that Rosenberg's financial situation was crumbling. The lawyers were scriveners, but knowing scriveners—and negotiators of key language in the closing documents. The nature and extent of the law firm's aiding and abetting liability under these circumstances warrants review.

III. THE RULING OF THE COURT OF APPEALS INSULATING ATTORNEYS FROM KNOWING PERPETUATION OF FRAUD IN PREPARATION OF CLOSING DOCUMENTS IS WRONG AND WARRANTS REVIEW.

The decision of the Court of Appeals effectively immunizes attorneys from liability to third parties even where attorneys knowingly deal with the victims (or victims' counsel) and incorporate lies into closing documents. This runs directly counter to the purpose of and precedents under the Federal Securities Laws.

The Complaint filed in this case outlines a horror story for the defrauded sellers of stock. Had Weinberg and Green either disclosed the material adverse changes that they were aware of in their client's financial statement or, failing that, withdrawn from participating in the deal closing, the Schatz' would not have suffered as they did. Simply stated, the facts alleged in the Complaint amply stated a cause of action under Section 10(b). The Court of Appeals affirmance of the Summary Dismissal of the Complaint warrants review.

CONCLUSION

For the reasons stated herein, Petitioners respectfully request that this Court issue a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

Respectfully submitted,

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